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MILLENNIUM CHALLENGE CORPORATION

[MCC FR 14-08]

Notice of Entering into a Compact with the Republic of El Salvador

AGENCY: Millennium Challenge Corporation.

ACTION: Notice.

SUMMARY: In accordance with Section 610(b)(2) of the Millennium Challenge Act of 2003 (22 U.S.C. 7701-7718), the Millennium Challenge Corporation (MCC) is publishing a summary of the Millennium Challenge Compact between the United States of America, acting through the Millennium Challenge Corporation, and the Republic of El Salvador. Representatives of the United States Government and El Salvador executed the Compact documents on September 30, 2014. The complete text of the Compact has been posted at <http://www.mcc.gov/documents/agreements/compact-112906-elsalvador.pdf>.

Dated: October 14, 2014.

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## **Summary of Millennium Challenge Compact with the Republic of El Salvador**

### **1. Overview.**

The Millennium Challenge Corporation (“MCC”) has signed a five-year, \$277 million compact with the Republic of El Salvador aimed at reducing poverty and accelerating economic growth (the “Compact”). The Compact is intended to assist the Government of El Salvador (“GoES”) to strengthen the investment climate, enhance the role of public-private partnerships in delivering key services, and improve the country’s productivity and competitiveness in international markets. Through intensive policy reforms and an integrated set of investments in the institutional capital, human capital, and physical capital of El Salvador, MCC expects that the Compact will help set the foundation for lasting economic growth and poverty reduction.

### **2. Background.**

This Compact will build on GoES reforms and initiatives and is informed by consultations with over 200 businesses. First, the Compact will invest in the institutional capital of El Salvador in order to enhance the investment climate by streamlining the regulatory environment and supporting the implementation of public-private partnerships. Second, the Compact will support policy reforms and invest in human capital to improve education quality and better match workforce skills with the demands of the labor market. Third, the Compact will invest in physical capital to reduce logistics and transportation costs by improving key road segments and border infrastructure in major transport corridors.

The Compact’s three projects represent a total investment of \$365.2 million, of which MCC will contribute \$277 million, and the GoES will commit \$88.2 million – a 32

percent matching contribution that is well above the 15 percent country contribution required for second compacts with lower-middle income countries.

### 3. Program Overview and Budget.

Below is a summary describing the components of the Compact. The budget and expected impacts are preliminary based on due diligence and project appraisal.

Compact Budget Overview

Project	MCC Funding	GoES Funding	Total Investment	Portion of Budget
	Millions of US\$			
Investment Climate Project	42.4	50.0	92.4	25.3%
Human Capital Project	100.7	15.0	115.7	31.7%
Logistical Infrastructure Project	109.6	15.7	125.3	34.3%
Monitoring and Evaluation	4.3		4.3	1.2%
Program Administration	20.0	7.5	27.5	7.5%
<b>TOTAL</b>	<b>\$277.0</b>	<b>\$88.2</b>	<b>\$365.2</b>	<b>100%</b>

### 4. Summary of Projects and Activities.

#### Investment Climate Project

The constraints to economic growth analysis and consultations with investors identified excessive “red tape” and discretionary application of rules as negatively affecting the investment climate in El Salvador. Firms also identified the need for key public infrastructure to increase productivity, but tight fiscal constraints and weak institutional capacity limit the ability of the GoES to provide such infrastructure. The Investment Climate Project seeks to address these deficiencies in El Salvador’s

investment climate by improving the regulatory environment and the GoES's capacity to provide key public services in partnership with the private sector through the following two activities:

- The Regulatory Improvement Activity will prioritize and promote investment climate reforms with the goal of creating a more efficient and profitable business environment. MCC will support the development of an institutional framework and system, including an independent institution focused on continuous regulatory improvement and the prioritization and implementation of a select set of reforms. The reforms will focus on areas critical to El Salvador's competitiveness in international markets and may include trade facilitation, border crossing and customs procedures, environmental permitting, and harmonization of municipal and national regulations. The regulatory improvement institution will also consider the extent to which regulations can be improved to reduce the potential for corruption. In designing and implementing reforms, the institution will ensure that the proposed reforms are consistent with the GoES's obligations under international trade and investment agreements, including the Dominican Republic-Central America Free Trade Agreement. As part of the activity, the GoES will commit to review, simplify and potentially eliminate regulations early in the Compact implementation process. Such concrete demonstrations of high level commitment to the reform process will be necessary to achieve a dramatic change in the perceptions of the business climate in El Salvador.

- The Partnership Development Activity seeks to enable the GoES to partner with private enterprise in innovative ways to provide critical public services in the face of tight fiscal constraints. The GoES has recently passed several laws to facilitate private

investment and trade. Most notably, the GoES legislature unanimously passed a law in May 2013 and subsequent reforms in May 2014 to facilitate public-private partnerships (“PPPs”) in the provision of key public services. MCC will invest in capacity building to properly develop, implement, and monitor such partnerships under this law. MCC will make available funding for transaction advisory services to develop and tender PPPs for two key infrastructure projects. Projects currently under review are the expansion of the El Salvador International Airport and a wind farm. MCC and the GoES are also sponsoring the El Salvador Investment Challenge (“ESIC”), a program to more efficiently and transparently allocate limited GoES resources to public goods needed to support private investment in the international trade of goods and services. The ESIC generated 74 investment project proposals in its initial call for proposals, of which 13 are being evaluated for the next phase of development. The GoES plans to institutionalize the ESIC as an instrument for attracting private investment and will contribute up to \$50 million to the ESIC during the term of the Compact.

The estimated economic rate of return (“ERR”) for the Investment Climate Project is 18.56 percent, using a weighted estimate of the calculated ERRs for each activity.

#### Human Capital Project

The quality of education in El Salvador is below what the country requires to be competitive in world markets. The Human Capital Project is designed to improve the quality of education and to better match the supply of skills of students coming out of secondary school with the demand of a labor market oriented towards international trade. The project consists of the following two activities:

- The Education Quality Activity supports complementary interventions to provide Salvadoran students the benefits of competency-based education, increased

classroom time, teachers trained in requisite subject-matters and pedagogical skills, and an institutional and physical environment conducive to learning. MCC's investment will strengthen the national education system by reforming the laws, policies, and operations that govern continuous professional development for teachers, student assessment, and information systems. The activity will strengthen and expand the implementation of the full-time inclusive school model, which increases classroom time from 25 to 40 hours per week, in an estimated 400 schools grouped in 45-55 clusters, focusing resources on grades 7-12. The curriculum improvement component will focus on English, mathematics, science and information technology, and other 21st century skills.

- The Technical, Vocational Education and Training (“TVET”) System Reform Activity seeks to harmonize the skills supplied by private and public TVET providers with the skills demanded by the labor market. The activity will strengthen the national TVET governance system by supporting legal, policy, and operational reforms within the system. MCC will support the establishment of a public entity governed by a board comprised of an equal number of public and private sector representatives to provide the legal and institutional framework for an integrated TVET system. The activity will also fund TVET curricula development with participation from the private sector, career counseling, and job-matching services. It will also fund the establishment of a framework and standards for accreditation of TVET training organizations and certification of teachers and students. The activity will also strengthen the capacity of the TVET system for identifying labor market trends that will inform the strategic direction of the TVET system, including the establishment of a monitoring and evaluation (“M&E”) framework and a labor market observatory.

The estimated ERR for the Human Capital Project is 11.35 percent.

### Logistical Infrastructure Project

The constraints analysis identified transportation and logistics as main factors contributing to the productivity and competitiveness of Salvadoran exports.

Consultations with businesses during Compact development also highlighted certain transportation and logistics deficiencies, including the need to expand and rehabilitate key road segments in the coastal zone of El Salvador. The Logistical Infrastructure Project is comprised of two activities designed to reduce logistical and transportation costs and relieve bottlenecks at critical sections along the logistical corridor that connects the main border crossing with Honduras at El Amatillo, the Ports of La Union and Acajutla, and the international airport:

- The Coastal Highway Expansion Activity seeks to relieve congestion at the most transited segment (27 kilometers) of El Salvador's coastal highway by expanding this road from two to four lanes. The coastal highway is one of the two most important logistical corridors in the country and connects the country's major logistical nodes along the Southern coastal zone of the country, including its two sea ports (La Union and Acajutla) and the international airport.

- The Border Crossing Infrastructure Activity seeks to relieve the freight and passenger traffic congestion at the border crossing into Honduras at El Amatillo by improving a 5.7 kilometer road leading to the border and modernizing the border-crossing facilities on the Salvadoran side. MCC will invest in the construction of control stations at the border, including buildings, internal access and connecting roads, parking

areas, water and sanitation, and other infrastructure components that may be necessary for the effective functioning of these stations.

The estimated ERR for the Logistical Infrastructure Project is 20.31 percent, using a weighted estimate of the calculated ERRs for each activity.

#### 5. Program Logic, Expected Results, and Beneficiaries.

In order for El Salvador to be competitive and raise productivity in internationally-traded goods and services, the factors of production in El Salvador must be competitive on world markets. Those factors include human capital, physical capital, and often logistics/transportation. The institutional environment can also affect productivity. As a result, the Compact takes a multi-pronged approach to enhance El Salvador's competitiveness in these factors of productivity.

By streamlining the business environment, improving the quality of education, and reducing transportation and logistics costs, MCC's investments are intended to increase the productivity of current firms involved in the trade of international goods and services, which is expected to increase current production (and subsequently, employment). Firms are then expected to invest new revenues in more productive technology to realize greater returns on future production. Higher employment and output are expected over time through this self-reinforcing feedback loop which is enabled by greater productivity in traded goods and services.

The expected beneficiaries of the Regulatory Improvement Activity are the firms operating in El Salvador (currently more than 25,000) that will experience cost savings as a result of regulatory reforms. The potential expansion of the El Salvador International Airport under the Partnership Development Activity is expected to decrease delays and



travel costs for travelers, while the wind farm project would increase the GoES's ability to attract investment for renewable energy. The beneficiaries of the ESIC are expected to be those firms whose proposals are selected for grant funding, workers who realize net income gains associated with employment as a result of the projects, and third parties who benefit from the public investment.

MCC expects the Human Capital Project to directly benefit students in grades 7-12 in general and technical education, who realize higher incomes as a result of more years of education. In particular, the project is expected to contribute to preventing or postponing the dropout of approximately 176,000 students. Direct beneficiaries of the TVET System Reform Activity are expected to be TVET students who receive higher incomes as a result of receiving skills that are better matched to labor market needs. Additional beneficiaries of the project include students who do not attend a full-time inclusive school but receive increased incomes as a result of improved quality of education that result from the implementation of reforms at the national level. Communities may also experience reductions in crime as a result of the full-time inclusive school model, due to increased permanence in school and lowered social vulnerability of students.

The beneficiaries for the Logistical Infrastructure Project are the estimated 171,159 individuals living within five kilometers of either side of the project sites. Because of the nature of the activities as key logistical thoroughfares, benefits in the form of reduced vehicle operating costs and travel time are expected to accrue to individuals and firms that travel along those corridors.

## 6. 2006 El Salvador Compact Update and Sustainability Information.

In November 2006, the Millennium Challenge Corporation signed a five-year, \$460.94 million compact (the “2006 Compact”) with the GoES to improve the economic opportunities of Salvadorans through strategic investments in agricultural production, rural business development, education, and transportation infrastructure. The 2006 Compact consisted of the following three projects:

1. The Connectivity Project, to reduce travel cost and time within the Northern Zone,
2. The Human Development Project, to increase the human and physical capital of residents of the Northern Zone and further employment and business opportunities, and
3. The Productive Development Project, to increase production and employment through technical assistance, credit guarantees, and capital investments.

The 2006 Compact entered into force on September 20, 2007 and closed on September 20, 2012.

### Key Achievements of the Compact are as follows:

- Connectivity Project: A total of 223.32 kilometers of road, including three large bridges, and 20 smaller bridges were constructed in northern El Salvador to help improve connectivity for farmers and local producers with the rest of the country. This east-west road in the north stretches close to the borders with Guatemala to the west and Honduras to the east, and the improvements have reduced travel time across the Northern Zone from 12 hours to 6.5 hours.

- Human Development Project:

Electrification: An estimated 35,412 households now have electricity in their homes, thanks to the installation of new power lines and solar power systems, helping to increase the percentage of households with electricity connections in the Northern Zone from 78 percent in 2007 to 90 percent in 2011.

Water and Sanitation: MCC funded about 272 kilometers of water pipes as part of the 2006 Compact's investment in water and basic sanitation that helped connect 7,624 households to potable water.

Education: MCC funded the construction of a new technical community college, improvements to a teacher training center, and the expansion and rehabilitation of 20 high schools. The rehabilitation of the high schools alone is expected to benefit more than 9,700 students every year.

- Productive Development Project: MCC funding assisted an estimated 17,500 producers through the provision of training, seeds, equipment, and technical assistance. The project provided 30 loans to small and medium-sized businesses in the Northern Zone to develop new or expand investments in the agriculture, tourism and handicrafts value chains. These loans totaled \$5.7 million, of which approximately 20 percent went to women-owned businesses.

Sustainability:

Although no contribution was required from El Salvador during the implementation of the 2006 Compact, the GoES contributed substantially in parallel to the Compact to enhance the success of the program.

The Connectivity Project: In the final year of compact implementation (2012), the GoES also carried out two road maintenance reforms, increasing annual road maintenance funding by about \$26 million (~37% increase). At the end of the five years, the GoES allocated an additional \$13 million to complete two remaining segments of the Northern Transnational Highway. During the four-month closure period, all activities under the 2006 Compact were successfully completed.

The Human Development Project's activities were extensions of existing GoES programs, built on the National Plan for Education 2021 and designed to strengthen and install permanent capacities in key Salvadoran ministries and institutions. In addition, the Ministry of Education agreed to fund infrastructure and equipment maintenance and continued an agreement with the Gloria de Kriete Foundation to fund scholarship for secondary education through 2014.

The Productive Development Project was designed to transition producers to higher-profit activities, generate new investment, expand markets and sales, and create new jobs in ways that stimulate sustainable economic growth and poverty reduction. Actions accomplished to ensure sustainability of investments made under the Productive Development Project included the establishment of contracts between beneficiaries and supported cooperatives and major retailers for the purchase of horticulture and dairy products. The Ministry of Agriculture also incorporated the project's beneficiaries into its national Family Agriculture Plan, its signature agriculture extension service aimed at improving the profitability of individual and small and medium-sized producers.

### Environmental and Social Sustainability:

As part of an effort to ensure environmental and social sustainability, all Projects included consultations with the public regarding various aspects of their implementation. The design of the Projects, including their major activities, was included in a strategic environmental assessment that was completed prior to implementation. The sustainability of the projects was also enhanced by the institutional capacity building and training in environmental management acquired through the close cooperation among the environmental units of the implementing agencies, the Millennium Challenge Account (MCA), and MCC. The Salvadoran Ministry of Environment (MARN) received Compact funding support to offset the additional regulatory costs associated with the Projects. Over the course of the Compact, collaboration improved between MARN and the environment units of the implementing agencies.

The GoES and private sector and civil society organizations have consistently worked to ensure the sustainability of the 2006 Compact and we expect them to continue to support these investments going forward.

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